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COMMENT

TESTIMONY
OF
PHUPINDER GILL

PRESIDENT OF THE CLEARING HOUSE
CHICAGO MERCANTILE EXCHANGE

BEFORE THE

COMMODITY FUTURES TRADING COMMISSION
CLEARING ORGANIZATION REINVENTION

JUNE 28, 2000

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INTRODUCTION

Mr. Chairman, members of the Commission, I am Phupinder Gill, President of the CME's Clearing House division. I have been with the CME since _____, and have served as Clearing House President since _____. The principles underlying the Commission's proposal for a new Part 39 regulatory framework are generally sound and forward looking. The Commission's proposed rulemaking respecting clearing organizations is founded on a high level of trust and respect for existing derivative clearing organizations. We believe that the CME Clearing House has earned that trust and respect through hard work and sound investment. We are rightly proud of the financial safeguard system of the CME, which blends advanced risk management techniques, substantial financial resources, and financial surveillance to protect clearing members and their customers. The keystone of our safeguard system is the CME's ability to evaluate risk and actively recalibrate our exposure. The judgments of the Clearing House are backed by the assets of the Exchange, the financial strength of its clearing members, and its special Trust Fund.

In the 125-year history of the Chicago Mercantile Exchange and its predecessor, there has never been a failure by a clearing member to pay settlement variation, to meet a performance bond call, or to deliver. There has never been a clearing member failure that caused a loss of customer funds. This system has been remarkably successful despite repeated episodes of incredible volatility. A complete description of our operations and policy can be found at the CME's web site: http://www.cme.com/market/safe.html

We have made substantial investments to prepare for the future. The Chicago Mercantile Exchange designed and, with the NYMEX, built CLEARING 21™. CLEARING21 was our response to dramatic changes that we foresaw in the derivatives industry. CLEARING21 has emerged as the standard for clearing derivatives and securities. CLEARING21 offers the following clear advantages.

- Real-time Processing: Designed for a world in which trading never stops, CLEARING 21 processes trades and tracks positions continuously, virtually in real time, without the delays inherent in older, batch-oriented systems. CLEARING 21 users have up-to-the-second data on trades, positions, money and risk available at all times.

- Flexibility: Market users need support for customized products with shorter product development cycles. Complex product types are easily accommodated, including

combinations, options on combinations, options on options, swaps, repos, etc. There are no limits on the complexity of products that can be cleared.

- Connectivity: The modern financial world is one of complex, multi-party agreements for trading and clearing linkages, cross-margining and common banking. CLEARING 21 supports all of these.

- Open Architecture: The open architecture of CLEARING 21 greatly expands the integration between clearing member firm systems and the clearing system. Member firm systems exchange messages with CLEARING 21, in real-time and around the clock, using a standard, message-based application programming interface (API).

- Accessible Interface: CLEARING 21 provides advanced client software with an easy-to-use graphical user interface for member firms and trader workstations. Much simpler to operate than older terminal-based systems, this software easily installs on standard PC hardware at clearing firms, providing instant access to all system functions and data.

The CME welcomes the opportunity to provide its view on the Commission's proposed rulemaking respecting clearing organizations. We support the Commission's efforts to reinvent the regulation of clearing organizations, but believe that the jurisdictional basis for Part 39 needs to be clarified. The Commission's proposal appears to reflect jurisdictional accommodations and claims that are not discussed in the proposal. We are concerned that the proposal raises a number of controversial issues that may disadvantage Commission regulated clearing organizations.

SCOPE

Section 39.1(b) is entitled "*Scope*." It is not clear what this subsection is intended to resolve. Obviously, it does not limit the transactions that an RCO may clear. Section 39.2(c) clearly permits an RCO to clear "transactions not specified in §39.1(b)(1)." A drafting error is part of the problem. The initial reference, "This section applies" is incorrect. "This section" is §39.1 and only includes "Definitions and Scope."

Like Parts 34 and 35, the subsection should begin, "The provisions of this Part 39 govern all transactions . . ." Section 39.1(b)(1) lists trades on designated contract markets, recognized futures exchanges under Part 38, derivatives transaction facilities under Part 37, exempt multilateral transaction execution facilities under part 36, and transactions exempted under Part 35. It does not include transactions involving hybrid instruments that are exempted under Part 34.[1] It does not include the host of other transactions that can be cleared by an RCO.

Correcting that drafting error, however, does not solve the jurisdictional issues raised by the "scope" of Part 39. Parts 34 and 35 deal with the jurisdictional issues by limiting their "scope" to instruments, "which may be subject to the Act . . ." Therefore, the application of the fraud, manipulation and Shad/Johnson provisions of the CEA to exempted swap transactions within the "scope" of Part 35 was appropriate since, by definition, those transactions were subject

[1] The Commission should explain why a hybrid within the "scope" of Part 34 is omitted from the list.

to the Act prior to the exemption. The "scope" provision of Part 39 includes no corresponding limitation.

Moreover, §39.1(b)(2) does not include any modifier limiting the reach of subparagraph (b)(2) to transactions within the "scope" of Part 39. Section 39.1(b)(2) deems an RCO "to be a contract market for purposes of the Act and Commission rules thereunder . . ." This determination imposes significant regulatory constraints. Although (b)(2) grants an exemption from "all provisions of the Act and Commission regulations thereunder except as reserved in §39.5 of this part [sic]," §39.5 reserves a substantial swath of the Act.

Presumably, subsections (b)(1) and (b)(2) must be read together. Therefore, the defined "scope" should be interpreted as a limitation to the declaration in §39.1(b)(2) that an RCO is deemed a "contract market for purposes of the Act, and the Commission rules thereunder." In consequence, §39.1(b)(1) and (2) should limit the application of the Act and Commission rules to an RCO to the extent that it is clearing a transaction within the defined "*scope*" but not if it is clearing a cash product or other product that is beyond the reach of the CEA. For example, if we clear spot electricity trades, there does not seem to be any jurisdictional basis to treat our clearinghouse as a contract market in respect of such transactions. At present, the CME trades a number of spot commodities without registration with the Commission. Part 39 should not treat clearing organizations any differently. We urge that the language be clarified.

If that interpretation is correct, then §39.6 which purports to prohibit fraud and manipulation in connection with all transaction cleared by an RCO, should be limited to transactions within the scope of Part 39.[2] Such a limitation may be a necessary adjunct of the statutory limitations on the Commission's jurisdiction. If this interpretation is correct, the title of that section should also be amended to avoid the jurisdictional issue. That clarification helps, but will not solve all of the jurisdictional issues.

A difficult question remains even if the Commission amends §39.1(b)(2) to deem an RCO a contract market only to the extent that it clears a transaction within the "scope" of Part 39. The "scope" definition applies to "exempt bilateral transactions under Part 35 of this chapter." It is not clear what is included under that rubric. The published proposed amendment to Part 35 does not include a revision to §35.1(a), the scope definition, although the existing reference to any "swap agreement" in that paragraph must be modified.

JURISDICTIONAL AND COMPETITIVE CONCERNS

If an RCO were deemed a contract market in respect of every bilateral agreement described by revised Part 35, significant jurisdictional concerns might be raised. While the Exchange has consistently argued that all swap contracts are contracts of sale of a commodity for future delivery within the Commission's jurisdiction, neither the Commission nor other interested participants in the derivatives industry have accepted that interpretation. In fact, the Commission created the Part 35 exemption, consistent with congressional exhortations, without determining

[2] In which case §39.6 might be superfluous because §39.5 reserves the fraud and manipulation provisions of the Act.

whether or not it had jurisdiction over the transactions exempted.[3] The Commission's "Statement of Policy Concerning Swap Transactions," 54 FR 30694 (July 21, 1989) is often interpreted as support for the proposition that many swaps are not governed by the Act.

The proposed language makes it seem that the Commission is attempting to expand its jurisdiction to include any OTC transaction that is submitted to an RCO. If the Commission does not intend that result, the solution is to deem an RCO to be a contract market only to the extent that it clears a transaction that involves a contract of sale of a commodity for future delivery. This is not an academic distinction. The OTC market has expended substantial resources to avoid subjecting itself or its transactions to the jurisdiction of the Commission. If an OTC market has the choice of clearing through a foreign clearinghouse or a bank regulated clearinghouse rather than an RCO, which will be deemed a contract market in respect of every transaction described by Part 35, RCO's will be placed at a devastating competitive disadvantage.

The submission of a transaction, otherwise outside the CEA, to a CFTC regulated clearinghouse does not logically bring the transaction within the Commission's exclusive jurisdiction. Designated contract markets can trade spot commodities without implicating the Commission's jurisdiction. If use of a clearinghouse brings transactions, otherwise outside the scope of the CEA, within the Commission's jurisdiction, then there is no reason to differentiate between transactions submitted to a CFTC, SEC or bank regulated clearinghouse. If clearing is the hook, then all clearinghouses are equal in terms of converting transactions into futures contracts.

The foregoing suggests to us that the Commission has not explained why its fraud, manipulation and Shad/Johnson proscriptions apply when a transaction is cleared by an RCO, but not when that same transaction is cleared by an SEC, bank or foreign regulated clearinghouse. The Commission has not made the required finding to support waiver of the Act's fraud, manipulation, etc. proscriptions for OTC futures transactions that are cleared under the supervision of other regulators. Even if the Commission could invoke its exemptive authority to favor SEC, bank and foreign regulated clearinghouses, it may not waive the proscriptions of section 2(a)(1) for their benefit.

In summary, the Commission cannot deem RCO's to be contract markets in respect of every transaction they clear without facing serious jurisdictional questions and creating competitive concerns. The Commission should not create a regulatory regime that favors clearinghouses subject to other regulators.

ALLOCATION OF JURISDICTION

The Commission asserts exclusive jurisdiction over clearing of transactions originating through designated contract markets, recognized futures exchanges and derivatives transaction facilities. A clearing organization governed by another regulator or a clearinghouse, which has no regulator, is prohibited from clearing such products. We agree with this allocation.

Transaction effected pursuant to Part 35, the swaps exemption, and Part 36, exempt

[3] H.R. Rep. No. 978, 102d Cong., 2d Scss. 82-83 (1992)

MTEFs, have a choice of clearing venues. Hybrid transactions subject to Part 34, regardless of whether they are subject to the Act, are not explicitly discussed. This omission suggests that transactions exempted under Part 34 might be treated differently than those governed by Parts 35 and 36. If there is a distinction, it is not explained in the proposal. If the distinction is that Part 34 transactions involve depository instruments and securities, that is an insufficient basis to explain the omission. Many swaps involve securities and bank deposits. We believe that additional work is necessary to rationalize these distinctions.

The proposal imposes no explicit limitations on the transactions that may be cleared by RCOs. We fervently support that position. Presumably, any limitations on the right of an RCO to clear subject to the Commission's exclusive jurisdiction will be imposed by law and regulation apart from the CEA. Unfortunately, silence on the issue of whether equity swaps and swaps involving other securities, such as government bonds, are or are not "contracts of sale of a commodity for future delivery" within the exclusive jurisdiction of the Commission may create a problem. The Department of the Treasury and the SEC have given strong signs that clearing of swaps involving such products should be subject to SEC regulation. If the Commission's laudable deregulatory efforts led to joint regulation of our clearinghouse, or forced us to split the clearinghouse into separate units, the benefits of the new regulatory framework would be lost.

Thank you again, Mr. Chairman, for the opportunity to include our written testimony in the record of this meeting.